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CHARLES ELMORE

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1940

No. 958

KETTLEMAN HILLS ROYALTY SYNDICATE No. 1 (a trust),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit
and
BRIEF IN SUPPORT THEREOF.

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ARGUMENT.

I.

The decision of the Circuit Court of Appeals holding that the successive decisions of petitioner to take its royalty in cash and not to take it in kind is the doing of business is in direct conflict with the decisions of the Circuit Courts of Appeals of other jurisdictions and in so holding said court has decided a federal question in a way probably in conflict with applicable decisions of this court | 15

A. Such holding is in direct conflict with the decisions of the Circuit Courts of Appeals of other jurisdictions | 15

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II.

The decision of the Circuit Court of Appeals in holding that the acts of petitioner in modifying its royalty contracts in connection with the oil operators' and government's oil and gas conservation program constituted the doing of business by petitioner giving rise to tax liability as an association, because petitioner exercised its business judgment in so doing, is in conflict with the decisions of the Circuit Courts of Appeals of other jurisdictions and in so holding said court has decided a federal question in a way probably in conflict with applicable decisions of this court | 24

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PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
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To the Honorable Charles Evans Hughes, Chief Justice of the United States, and to the Associte Justices of the Supreme Court of the United States:

Your petitioner, Kettleman Hills Royalty Syndicate No. 1, a trust, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered December 19, 1940, wherein that court in an

opinion (R. 138) reported in 116 Fed. (2d) 382, affirmed a decision of the United States Board of Tax Appeals. The memorandum opinion of the Board of Tax Appeals is unreported (R. 32).

JURISDICTION.

Judgment of the Circuit Court of Appeals was entered December 19, 1940 (R. 143). Petition for rehearing, filed January 17, 1941, was denied on January 21, 1941 (R. 144). The jurisdiction of this court is invoked under 28 U.S.C.A. Sec. 347 (Jud. Code Sec. 240, as amended).

QUESTIONS PRESENTED.

This petition presents the following questions:

1. Whether the making of successive annual tacit decisions by trustees of a common law trust of quasi-corporate form over a period of years and from the inception of said trust always to receive in cash royalties to which the trust was entitled by contract from oil and gas production by others, rather than in kind, is the doing of business rendering said trust liable to income and excess-profits taxes as an association for that reason under the provisions of Sec. 801(a)(2) of the Revenue Act of 1934 and/or Sec. 1001(a)(2) of the Revenue Act of 1936, where by virtue of its royalty contract the trustees could have elected not oftener than once a year to receive said royalty in kind, and where the provisions of the trust

indenture creating said trust were sufficiently broad to have permitted said trust to store, sell and otherwise treat and dispose of such oil and gas had such election to take in kind been exercised?

2. Whether the acts of petitioner in consenting as a royalty holder to its obligor's assignment of government "A" and "B" oil and gas leases to a corporation organized by the operators in the so-called North Dome of Kettleman Hills oil field in Kings County, California, for unified development, conservation and production of oil and gas in said field and similarly consenting as royalty holder to the assignment by its obligor as lessee of government oil and gas leases with respect to the so-called Middle Dome of said oil field, pursuant to requests for such consents made to petitioner by its obligor and representatives of the Department of the Interior in connection with a governmental oil and gas conservation program then being carried out in said area, accompanied by petitioner's execution of agreements with its obligor modifying its original royalty contracts to the extent of providing for the payment to it of the same percentages of royalty, but from obligor's pro rata of the general production from the area subject to the conservation arrangement, rather than from the specific acreage covered by the original royalty contracts (except that as to the North Dome area petitioner's royalty as to "B" acreage was increased from 2½% to 3½% while subject to such conservation plan), constituted the doing of business by petitioner rendering it liable to income and excess-profits taxes as an association for that reason under

the provisions of Sec. 801(a)(2) of the Revenue Act of 1934 and/or Sec. 1001(a)(2) of the Revenue Act of 1936, where the reason given by the court for such holding of doing business was that such acts required the exercise of petitioner's "business judgment"?

STATUTES INVOLVED.

The Revenue Act of 1934 (C. 277, 48 Stat. 680, Sec. 801(a)(2) (26 U.S.C.A. Sec. 3797(3)) provides that:

> "Sec. 801. Definitions.
> (a) When used in this Act—
> (2) The term 'corporation' includes associations, joint-stock companies, and insurance companies."

Subsections (a)(2) of Sec. 1001 of the Revenue Act of 1936 (C. 690, 49 Stat. 1648, Sec. 1001(a)(2)) are identical with those quoted above.

STATEMENT.

A summary statement of the facts, which were all stipulated, and found by the Board of Tax Appeals as stipulated (R. 33, 42-122), follows:

Under date of July 9, 1924, as modified by an agreement between the same parties dated February 9, 1930 (R. 86), one Smith entered into a contract with Associated Oil Company, a corporation, hereinafter called Associated, whereby said Smith as the owner by assignment of a certain United States oil

and gas prospecting permit covering certain lands in what is known as the "Middle Dome of Kettleman Hills oil field" in Kings County, California, authorized Associated to enter said property, make discovery of oil or gas, secure a government lease, and operate said property in the production of oil or gas, reserving a royalty of one-sixth of the net production therefrom (R. 42, 82).

Under date of May 5, 1928, the same parties entered into a contract (R. 91) whereby Associated agreed to pay said Smith the sum of $5000.00 on the production of oil or gas and overriding royalties of 7½ per cent and 2½ per cent of the value at the well of oil and gas produced and sold by Associated under government "A" and "B" oil and gas leases respectively, when secured by Associated on lands in what is known as the "North Dome of Kettleman Hills oil field" in Kings County, California, covered by an oil and gas prospecting permit in the name of one Watson (R. 42, 43). Said contract provided that at Smith's option, exercised not oftener than once in any one calendar year, Associated would deliver said royalty in kind (R. 92).

Smith assigned his interest in said contracts to one Jacoby (R. 43).

Subsequent thereto, on May 3, 1930, an agreement and declaration of trust was entered into in writing by and between said Jacoby and the three trustees of petitioner, wherein and whereby, said Jacoby, as Smith's successor in interest, assigned said contracts to said trustees in consideration of their issu-

ance to him of 4000 transferable units of beneficial interest in said trust, representing the entire beneficial interest in the trust estate thus created (R. 43-45), each unit entitling the holder thereof to receive a one-four-thousandth pro rata of the royalties and other income received by the trustees, after the deduction of costs and expenses of administration of the trust (R. 45). Jacoby sold these units to the public for his own account, so that the units were acquired and are now held by various holders (R. 45-46).

Said trust agreement provides *inter alia* (R. 59-95): that the trust is to continue for twenty-five years (subject to prior termination by the trustees if oil and gas should cease to be found and produced in paying quantities upon the properties covered by said contracts (R. 79)) through three self-perpetuating trustees (R. 70), the beneficiaries having no vote or voice in its management; its affairs to be conducted through meetings of its trustees by resolutions adopted by them, its resolutions being kept in a minute book for that purpose; the trustees to hold in trust the legal title to all property at any time belonging to the trust with the exclusive management and control of the same (R. 68); the trustees to collect and distribute the net income and profits therefrom to the holders of its certificates and to carry out the obligations of Jacoby with Associated Oil Company, including payment of taxes, execution of leases, drilling of any and all oil wells required or permitted, receiving, storing and selling oil products; the trustees being authorized as successors to

Jacoby in and to said contracts, should occasion arise (R. 65) to develop and drill for oil and gas, to buy and sell oil products and to make contracts generally as required to protect said royalty contracts; neither the trustees nor the beneficiaries to be personally liable for obligations of the trust, which shall bind the trust estate only (R. 71).

On August 14, 1931 (R. 47, 106) the trustees adopted a resolution, and entered into a contract with Associated, dated June 15, 1931, wherein the trustees agreed to accept until April 1, 1931, 7½% of the value of oil and gas distributed to Associated under a conservation and unified development program for the North Dome Kettleman Hills oil field in lieu of the royalties for said period provided to be paid by said agreement of May 5, 1928. The trust was paid by Associated at said time the sum of $5000.00 to which it was entitled under said contract on the production of oil or gas from the lands embraced in said Watson permit (R. 91, 109).

Associated made discovery of oil or gas under said Watson permit satisfactory to the Secretary of the Interior and under date of September 30, 1930, United States Government "A" and "B" leases were issued to Associated as lessee (R. 48). In the interests of economy and conservation the operators in the North Dome area, including Associated, formed a corporation having the corporate title of "Kettleman North Dome Association" to which were assigned various government oil and gas leases for unified development, conservation and production, each assignor being entitled to a pro rata of the general production

from the lands held by said corporation, rather than the entire production from the specific land covered by the respective leases thus assigned. Associated assigned its "A" and "B" leases to said corporation and requested petitioner herein, as a royalty holder under said leases, to consent to such assignment (R. 49). Following conferences between the trustees of petitioner, Associated and representatives of the Department of the Interior interested in said conservation program such consent was given (R. 49) by the adoption of a resolution by the trustees and petitioner's execution of an agreement with Associated under date of August 10, 1932, modifying said royalty contract of May 5, 1928, to the extent of petitioner's consenting as a royalty holder to said prior assignment of said government leases by Associated to Kettleman North Dome Association and agreeing to accept its royalty based on Associated's pro rata of the general production, as aforesaid, rather than on the specific acreage covered by the original agreement of May 5, 1928, except that the royalty on the "B" acreage was increased from 2½% to 3½% while subject to such conservation plan (R. 111).

On September 20, 1933, at the request of Associated and representatives of the Department of the Interior (R. 51) interested in the conservation program, petitioner adopted a resolution whereby it consented as a royalty owner to Associated's becoming a member of Middle Dome Corporation and to receiving its royalty under its contract of July 9, 1924, from Associated's pro rata of the total production under the cooperative drilling and conservation plan

rather than from the specific acreage covered by said contract (R. 52-55).

The sole and only income ever received by petitioner has been the payments of the $5000.00 and the royalties in cash, starting in 1931, both pursuant to said royalty contract of May 5, 1928, as modified by said agreements of June 15, 1931 and August 10, 1932, with respect to the Kettleman North Dome conservation arrangements (R. 55, 56).

Petitioner has never elected to, or received, any royalty in kind (R. 55-56). Petitioner has never taken any act or adopted any resolution dealing with the receiving, or not receiving, of royalty in kind.

All of said income, less expenses of management and taxes, has been distributed pro rata from time to time as accumulated to the holders of said certificates of beneficial interest (R. 56).

Petitioner has never had any regularly employed personnel, or employees, other than the trustees themselves, two of whom act as counsel and bookkeeper respectively (R. 56, 57).

The sole and only assets of petitioner at all times have been said contracts with Associated, which have remained in full force and effect, except as modified as hereinbefore set forth, the government leases referred to, or contemplated therein, having been secured and held by Associated in Associated's name as lessee (R. 57).

Except as herein set forth, the sole and only activities of petitioner and its trustees at all times since

its creation have been the receipt and disbursement of royalty payments in cash, as aforesaid, and incidental duties, such as meetings of the trustees, keeping of books, transferring of certificates of beneficial interest and the making of Federal and state returns and reports (R. 57, 58).

On the foregoing facts the Commission of Internal Revenue determined income and excess profits tax liabilities against petitioner for the tax years 1934, 1935 (R. 11) and 1936 (R. 23) in the aggregate amount of $7634.40 solely on his conclusion that petitioner was "an association" taxable as a corporation, rather than a trust. Two separate petitions for redetermination were filed by petitioner with the United States Board of Tax Appeals.

RULINGS OF THE BOARD OF TAX APPEALS AND THE COURT BELOW.

In an unpublished consolidated memorandum opinion (R. 32) the Board of Tax Appeals determined that petitioner was an association during the tax years in question and held petitioner liable for tax deficiencies as determined by the Commissioner. Decision was entered accordingly (R. 41).

The Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals and held petitioner liable to income and excess-profits taxes at corporate rates as an association (R. 138).

REASONS FOR GRANTING THE PETITION.

1. The decision of the Circuit Court of Appeals in holding that the successive decisions of petitioner to take its royalty in cash and not to take it in kind is the doing of business by petitioner giving rise to tax liability as an association (predicated on the court's argumentatively assumed hypothesis that had petitioner elected to take in kind it would have been obliged to engage in the business of selling such material, with the power given in the trust indenture so to do (R. 141)) is in conflict with the decisions of the Circuit Courts of Appeal of other jurisdictions, namely:

Gardiner v. United States, 49 F. (2d) 992 (C.C.A. 1);

Dunbar et al. v. Commissioner of Internal Revenue, 65 F. (2d) 447 (C.C.A. 1);

Myers v. Commissioner of Internal Revenue, 89 F. (2d) 86 (C.C.A. 7);

Cleveland Trust Co. v. Commissioner of Internal Revenue, 115 F. (2d) 481 (C. C. A. 6) (Pet. for Cert. denied, 85 L. Ed. Advance Opinions 664);

United States v. Davidson, 115 F. (2d) 799 (C.C.A. 6).

2. In so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with applicable decisions of this court, namely:

Zonne v. Minneapolis Syndicate, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428;

McCoach v. Minehill R. R. Co., 228 U. S. 295, 33 S. Ct. 419, 57 L. Ed. 842;

Morrissey, et al., Trustees v. Commissioner, 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289.

3. The decision of the Circuit Court of Appeals in holding that the acts of petitioner in modifying its royalty contracts in connection with the oil operators' and government's oil and gas conservation program constituted the doing of business by petitioner giving rise to tax liability as an association, because petitioner exercised its business judgment in so doing (R. 142), is in conflict with the decisions of the Circuit Courts of Appeal of other jurisdictions, namely:

Cleveland Trust Company v. Commissioner of Internal Revenue, 115 F. (2d) 481 (C.C.A. 6);

United States v. Davidson, 115 F. (2d) 799 (C.C.A. 6).

4. In so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with an applicable decision of this court, namely:

Morrissey, et al., Trustees v. Commissioner, 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289.

CONCLUSION.

For these reasons it is respectfully submitted this petition should be granted.

Dated, San Francisco, California,
April 14, 1941.

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